

Innovative strategies devised by Indian microfinance institutions to achieve cost efficiency

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Abstract

This study is a discussion on the ‘Non-Governmental Organization-Microfinance Institution Partnership Model’ and ‘Securitization Model’ used by Indian microfinance institutions to achieve cost efficiency. These two models are effective strategies devised and used by efficient and sustainable Indian MFIs to reduce their operating cost and financing cost. Achieving such cost efficiency is crucial for microfinance institutions to attain operational self-sustainability without levying high interest rates. Using interview method the study elicits information on these innovative strategies and recommends them to be worthy of emulation for other microfinance institutions operating in the Indian microfinance industry.

Keywords: Strategy, India, Microfinance Institutions, Cost Efficiency

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1. Introduction

Microfinance refers to the provision of financial services to low-income clients. By providing financial access to the poor clients, microfinance plays a decisive role towards financial inclusion. It economically empowers the poor and integrates them to the mainstreams of the economy. The institutions that provide such financial services to the poor are called Microfinance Institutions (MFIs). These MFIs act in an environment of high information asymmetric credit market risk, where there is a dearth of information about the credit history of the poor clients. These information asymmetric credit market risks are mitigated by the MFIs by using unconventional group lending models that work on joint-liability principle, sans collaterals. Though this unconventional group-lending model has the potential to mitigate risk and facilitate financial intermediation at the bottom of the pyramid, it has one major challenge associated with it—high intermediation costs. In order to cover this high intermediation costs and attain operationally-self sustainability (OSS), it is imperative that MFIs remain cost efficient.

OSS denotes the ability of MFI to earn revenue to cover its costs and reach the poor now and in future (Schreiner, 1996). More specifically, it is the ability of MFI to generate enough revenue from its operations to cover its financing costs, transaction cost and loan loss provisions. Attaining OSS is imperative for the MFI to perpetually operate in the sector. In order to attain OSS, without resorting to the practice of levying high interest rate from the poor, it is essential that MFIs concentrate on achieving cost efficiency.

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Considering the pertinence of achieving cost efficiency, this work aims to understand the innovative strategies used by efficient and sustainable MFIs, to remain cost efficient. This is expected to provide a valuable learning experience for other MFIs which aim to improve its cost efficiency.

2. Literature Review

Information asymmetric risk arises in credit-lending transactions, as the lender has less information about the creditworthiness of the borrower, than the borrower himself. Such risks are all the more exacerbated in microfinance market as the poor borrowers lack credit history. Information asymmetric credit market risks denotes the ex-ante risk of adverse selection¹, interim risk of moral hazard² and the two ex-post risks of costly audits and enforcement³ (Akerlof, 1970; Scholtens & Wensveen, 2003; Stiglitz & Weiss, 1981).

MFIs mitigate these information asymmetric credit market risks—adverse selection, by affecting group formation among the poor borrowers with joint-liability; moral hazard, by inducing group members to influence the way other members select their projects; costly monitoring, by helping the lender avoid external audits and enforcement problems, by encouraging borrowers to repay their loans without the lender having to impose sanctions—by its unconventional group lending models (Ghatak & Guinnane, 1999; Ghatak, 2000).

But the group-lending model used by MFIs to mitigate these risks, results in high operating costs for the MFIs (Thorat, 2006; Savita, 2007). The group lending models entails peculiar costs such as group formation costs, costs of training the borrowers on the procedures, costs of higher degree of supervision and higher frequency of installment payments, all adding to the operating costs of the MFI. Moreover since the average microfinance loan size is small, the transaction cost on a percentage basis for such microfinance loan tends to be higher. Adding to this, the MFIs experience less control over their financing costs, as cost of funds sourced from banks and financial institutions usually comes in fixed ranges of pricing. Thus the high intermediation costs incurred by MFIs are a major challenge at the stake of its sustainability.

In Indian microfinance industry, the average operating costs, ranges from nearly 6 to 18 per cent and the average financing costs, ranges from nearly 10 to 14 per cent of interest rates levied by the MFI (Chakraborty, 2010). The Malegam Committee, a special sub-committee appointed by Reserve Bank of India during the post-microfinance crisis period in India, cited that on an average the interest rate charged by Indian MFIs comes to 28-36 per cent in the year 2009-10. The Malegam Committee Report (2011) also cites few large Indian MFIs to be levying interest rates close to 50.53 per cent. This depicts that on an average the Indian MFIs experienced its operating costs and financing costs to be on the higher end of the average. This makes them charge higher cost-covering interest rates from the poor clientele, so as to remain sustainable. But after undertaking an efficiency and sustainability assessment on a sample of 50 Indian MFIs for the year 2009-10, Nadiya & RadhaRamanan (2011) cite the presence of few efficient MFIs, which operates sustainably by levying a reasonable interest rate of 26 per cent⁴ or lower from the poor. It is of interest to know how these efficient and sustainable MFIs are managing their operating costs and financing costs, as the strategies used by them can be emulated by other MFIs aiming at cost efficiency.

1. Adverse selection risk arises when the lender has poor information about the borrowers while negotiating the credit-lending transaction. With the limited information on the poor borrowers, the lender cannot screen the riskier borrowers from safer ones. Therefore there is an adverse selection risk of lending to the more risky borrowers.

2. Moral hazard risk arises because the lender has difficulty in monitoring the behavior of the poor borrowers once the loans are disbursed. Therefore, the lender does not know whether the loan is being used optimally for the intended purpose for which it is sanctioned. The lender lacks information about the performance of the credit-lending transaction and the probability for the loans disbursed to be misused, results in the risk of moral hazard.

3. Costly audit and enforcement risks arise, because it becomes too costly for the lender to audit and enforce payments on the small loans disbursed to the poor, which lack collateral support.

4. The Malegam committee (2011) identified 26 per cent as a reasonable interest rate for Indian MFIs and capped interest rates at this rate for MFIs operating in Indian microfinance industry.

This study therefore dedicates efforts to understand the innovative strategies used by two of these efficient and sustainable Indian MFIs. One of the MFIs which experiences low operating costs than the market average is approached to understand the strategy devised and used by them to reduce operating cost. Another MFI which has low financing costs than market average is approached to understand how they reduce their cost of funds.

3. Methodology

The method of semi-structured interviews is used to understand the strategies used by the MFIs. The method of interview is chosen as it will enable the participants (MFI managers) to freely express their views and discuss the strategies used for reducing cost. The names of the interviewed MFIs are not disclosed in this study due to confidentiality reasons. Therefore the manager of the MFI with low operating cost⁵ is proxied by the name 'MFI A' and MFI with the low financing cost⁶ is proxied by the name 'MFI B'. The managers of MFI A and B were asked to explain the innovative strategies they use to reduce operating costs and financing costs respectively. The strategies are documented for the reference of other Indian MFIs.

4. Non-Governmental Organization-Microfinance Institution Partnership Model to Reduce Operating Costs

The manager of MFI A uses the Self-Help Group (SHG) credit delivery model to disburse credit to the poor clients. SHG credit delivery model is the home grown credit delivery model used by Indian MFIs. In this model affinity groups of around fifteen to twenty poor individuals are formed. The SHGs mostly comprises of women with a homogeneous socio-economic background, sharing the willingness to improve their living conditions. The SHGs serve as a platform for a range of welfare services that can empower the poor women. The group members in an SHG provide financial support to one another through internal credit assistance made from their pooled savings. Later after inculcating financial discipline among themselves, the SHGs borrow from MFIs, for on-lending to the group members.

MFI A observes that there is huge group formation costs associated with the SHG model, prior to the commencement of the financial intermediation activities. In order to ensure that the groups are mature enough to be linked to the MFI, the latter provides training and nurturing activities for the members, prior to the issue of the first loan. Such initial group formation and nurturing activities was found imperative for empowering clients for whom credit is not the only missing link to development. For MFI A such activities usually spread over a period of 6 months, accounting for around INR 7000 per group. MFI A considers this to be a major chunk of its operating cost which forms an inevitable part of its credit delivery model. In due course of its operations, it devised an innovative strategy to deal with this high group formation costs. MFI A found that it would be possible to considerably reduce the higher group formation costs of SHGs by entering into Non Governmental Organization (NGO)-MFI partnerships. This partnership model is regarded as an innovative strategy devised by MFI A, as it was the first Indian MFI to adopt this model in Indian microfinance industry. MFI A partnered with an NGO and outsourced its group formation and nurturing activities to the latter at a nominal cost. The manager states:

"We pay 350 INR per linkage or in special cases 1 per cent of the loan amount lent to the NGOs as commission. The actual cost of group formation comes to 7000 INR per group. Cost savings for us on account of this partnership is around 6650 INR per group."

The NGO-MFI partnership model is depicted below in Figure 1.1.

6. Operating cost to gross loan portfolio ratio for MFI A is 4 per cent as on 2009-10, while the market average comes to 6 to 18 per cent.

MFI B sources funds from banks at 8.75 per cent interest rate as on 2009-10, while the normal lending rate of the bank comes to 10-14 per cent.

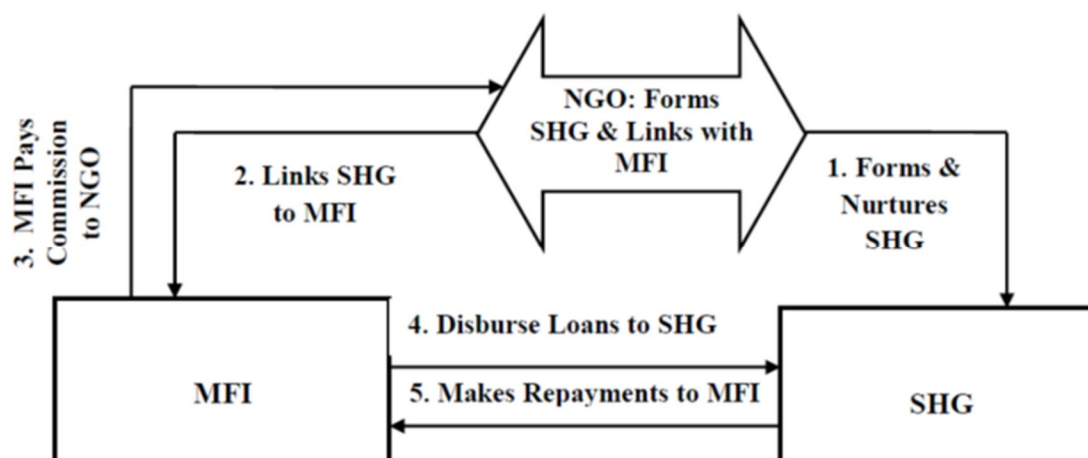


Figure 1.1 Non-Governmental Organization-Microfinance Institution Partnership Model

As shown in Figure 1.1, the MFI enters into a partnership with NGO, whereby the latter forms the SHGs and links it to the former. The MFI pays a commission to the NGO for facilitating and undertaking this group formation task. The NGO usually have affinity groups of poor affiliated to them for activities related to its own welfare mission and therefore they normally do not have to put in additional efforts to form SHGs. The NGO interacts with the group members on a day-to-day basis and therefore inculcating financial discipline among the members, is done hand-in-hand with their normal activities. The commission received from the MFIs for undertaking this group formation and nurturing services, serves as an additional income for the NGO, though it is usually a minimal amount. From the NGO's perspective, by linking the SHGs with MFI, they are able to address the capital constraints faced by their poor clients who undertake income-generating activities. This advantage, acts an incentive for the NGO to form SHGs, without compromising on the financial discipline of the members. Identifying such NGOs, which have a motivation to enter to this partnership, is crucial for the success of the model.

From the MFI's perspective, this partnership relieves them from undertaking the group formation and nurturing activities, thereby enabling them to concentrate more on its core activity of financial intermediation. Thus in the NGO-MFI partnership model, MFI A which otherwise incurs 7000 INR on group formation, outsources this task to NGO for a nominal fee of 350 INR. This results in a saving of 6650 INR for the MFI. Therefore in this model the MFI merely lends loans to the SHGs, which are already formed and nurtured by the NGO. The SHGs then directly makes the repayment of the loans to the MFIs. The repayment of loan by the group members is not the NGO's responsibility. But in the MFI's experience, since loan delinquencies adversely affect the NGO's chances to sustain the capital support for their clients, the NGOs takes special care to ensure quality and financial discipline of the groups formed. Therefore, the MFI has never experienced this partnership to adversely affect its portfolio quality. Overall, NGO-MFI partnership is an effective strategy that MFI A recommends for minimizing operating cost.

5. Securitization or Portfolio Buy-out Model for Reducing Financing Costs

Manager of MFI B observes that financing costs of MFIs are almost uncontrollable in nature. This is so as the rate at which MFIs source funds from banks is almost fixed in nature. Cost of funds always averages around 12-13 per cent for majority of MFIs in the industry. Nevertheless, MFI B uses and recommends the adoption of securitization model to reduce financing costs of MFIs. MFI B was among the pioneers to have applied the securitization model to Indian microfinance context. Though a popular model in banking sector, this had fewer applications in Indian microfinance industry, until MFI B proved the potential of this strategy to reduce financing costs for MFIs. In this sense the strategy is novel and innovative in microfinance context.

Reserve Bank of India permits only Non-Banking Finance Company (NBFC)-MFIs to use the securitization refinance option. MFI B being an NBFC-MFI uses this route to reduce its cost of finance. Manager of MFI B which uses this method says:

“Injection of a large amount of capital at lower costs is possible through securitization. We have 22.22 million USD worth loan portfolio securitized with bank. It allows us to liquidate the loans before they actually mature and thereby obtain cheap funds to make room for fresh asset creation. The cost of funds on securitized deal is approximately 8.75 per cent. This is far lower than the normal cost of funds for MFIs which is at 12 to 13 per cent.”

The securitization process as explained by the manager is presented below in Figure 1.2.

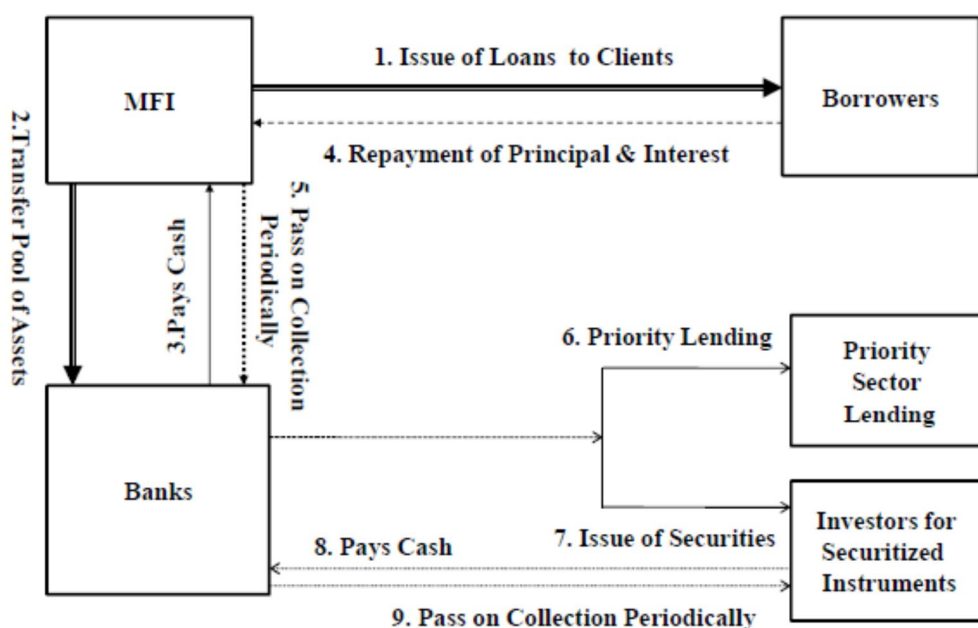


Figure 1.2 Securitization Process

As shown in Figure 1.2, after issuing loans to the clients, the MFI transfers the loans to banks interested in a securitization deal. The bank which purchases the pool of assets then pays back cash at a discounted rate of interest to the MFI. The MFI will continue to service the sold out loans on behalf of the bank and will pass on the collections periodically to the bank. The MFI will be financially responsible for any losses on the sold out loans, up to a certain percentage as agreed at the time of the securitization contract. This clause is termed as first loan default guarantee in the contract.

Just as the MFI gets its loans liquidated, the bank too has an advantage in entering in such a deal. The bank can use this purchased loans to fulfill their priority sector lending requirements. It can also pool these assets and redistribute it as securities to new investors. For the investor, securitized microfinance loans are attractive as it mature much faster than other industry investments. The maturity period ranges from 6 months to 3 years and portfolio quality is generally high on microfinance loans. Thus securitization is a win-win deal for all the parties involved. But since there is no active secondary market for securitized microfinance instruments, usually the banks either use it to meet their priority lending requirements or resell it to other banks that face the similar need. So if the redistribution element in this model is not there, then it becomes a mere portfolio buy-out model between the MFI and the bank, with no issue of securities. MFI B suggests that such portfolio buy-out model can be used by the non-NBFC MFIs. So the MFI recommends the use of either the securitization or portfolio buy-out model as a means to reduce their cost of funds.

6. Implications for Indian Microfinance Managers

Based on the discussions in this paper, it is suggested that the NGO-MFI partnership model can be used for reducing operating costs of Indian MFIs that use SHG credit delivery model. The MFIs which emulate this model are recommended to select NGOs which have the motivation to enter and retain the partnerships. This is crucial for ensuring cost advantage without compromising on portfolio quality. The NBFC-MFIs are recommended to use the securitization model for reducing financing costs. Whereas the Non-NBFC MFIs are suggested to use portfolio buy-out model to reduce its cost of funds. As the MFIs cannot rely on continued donor support for funding its operations, adopting strategies that reduce the cost of funds sourced from banks and financial institutions is crucial.

7. Conclusion

This study presents a discussion on two strategies that can be used to reduce the operating and financing costs of Indian MFIs. Using interview method the study elicits information on how these innovative strategies have been effectively used by two efficient and sustainable Indian MFIs, to reduce their costs. Thus the study disseminates information on the strategies that can effectively contribute towards the cost efficiency and OSS of Indian MFIs. Based on the discussions in this paper, it is recommended that these strategies are worthy of emulation for other Indian MFIs which aim to attain cost efficiency and OSS.

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